

Fed action-led correction in asset prices & markets some time away

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Synopsis

While the markets are cautiously watching for the historical unwinding of liquidity scenario, we believe that event of global central banks tapering their asset purchases is still a quarter or two away and the subsequent increase in interest globally will take longer than that.



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He has over 20 years of experience in the investment management industry. Prior to Bajaj Allianz, he was fund manager at Principal Mutual Fund. He has also worked as equity research analyst with HSBC Securities and ABN Amro Asia Equities during his long innings in the industry.

The Covid-19 pandemic has resulted in severe loss of life, economic activity and has caused turbulence for everyone in several walks of life. All of us have been exposed to this pandemic and have felt the aftermaths of the disease affecting our near and dear ones. The pandemic has come at a great cost to all of us, some which we have borne already and others which might be borne in the months and years to come. I strongly believe that our scientists and medical professionals would be able to overcome the mutations of the virus with vaccines and medications going ahead

Despite what the pandemic has done to us, there has been an overall positive impact on the financial markets led by liquidity. Contrary to many expectations, corporate earnings have also been resilient and in fact have grown by about 20

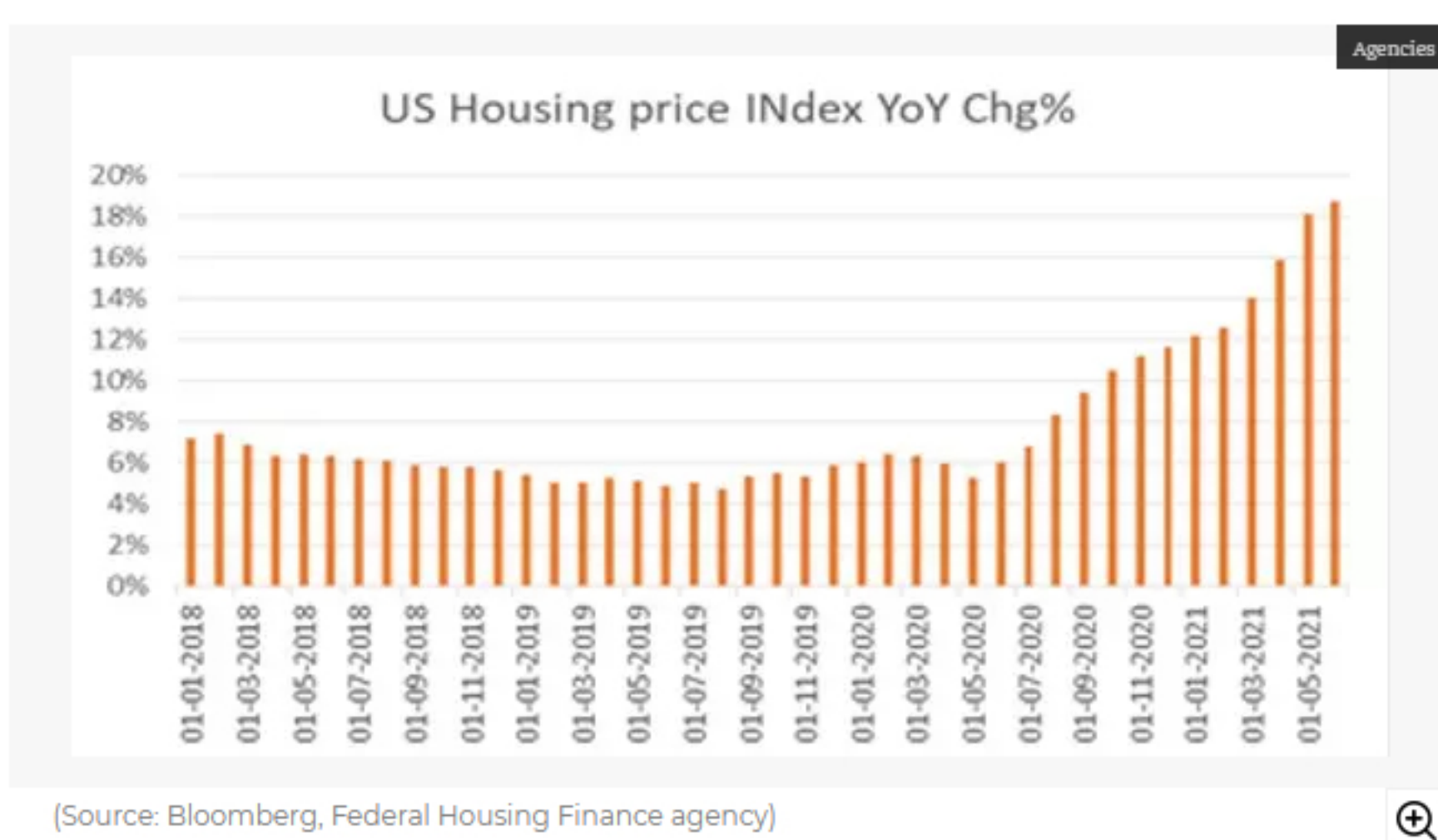
per cent led by some of the commodities and cyclicals. The monetary response of the global central banks including RBI as well as the fiscal response of governments the world over towards the pandemic has been extremely swift and massive. This has resulted in a flush of liquidity in the system and has been effective in arresting any severe fallout on the economic activity front. We have not only managed the economic lockdown period with a good corporate earnings growth, but the growth is sustaining into FY22 and FY23.

The US consumer price inflation has moved past over 5 per cent in the US. In India as well the consumer price inflation is around 6 per cent currently. It is widely believed that this higher inflation is due to sudden surge in demand as well as supply side constraints and hence could be transient in nature. However, some of the other price indicators such as commodities and housing price inflation seems to suggest that the inflation could be sticky.

The table here gives the rise in prices of different commodities and housing price inflation from 31st Dec 2019 to now, which encompasses the pre and post pandemic period. The spike in commodities from pre pandemic to now is visible and of course some of it is driven by supply side shock. But the contribution of easy liquidity scenario to the inflationary impact cannot be ignored. The US housing price index mentioned in the chart below highlights the spike in housing prices which stands at ~19 per cent currently as compared to last year.

Agencies			
COMMODITY	Current price	31 DEC 2019 Price	Appreciation
LME METALS INDEX	4,210.50	2843.3	48%
LME COPPER	9,356.00	6174	52%
LME ALUMINUM	2,617.50	1810	45%
LME LEAD	2,318.00	1927	20%
LME TIN	32,915.00	17175	92%
IRON ORE	145.92	85.97	70%
CHINA HRC (CNY)	5,728.00	3843	49%
LUMBER	491.10	405.3	21%
SUGAR	19.73	14.17	39%
BRENT	71.85	66	9%
NATURAL GAS	3.92	2.189	79%
SOYBEAN	1,328.75	952.5	40%
PALM OIL	4,578.00	3041	51%

(Source: Bloomberg, Federal Housing Finance agency)



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The US Federal Reserve in its 106 years of existence prior to the pandemic had an outstanding balance sheet size of \$4.2 trillion as on Dec 2019. Due to the Covid pandemic the **fed** balance sheet doubled in size to \$8.3 trillion, an indication of the wall of liquidity. The European Central Bank (ECB) which had a pre-pandemic balance sheet size of 4.7 trillion euros also saw a similar proportional increase in size in relation to that of the US Fed, effectively increasing to 8.2 trillion euros.

While the monetary stimulus was essential in the immediate term to curb any kind of financial distress, the inflationary nature of the stimulus has started appearing steadily and we are beginning to see the impact of this liquidity on asset and commodity prices. We believe the current bull market is to some extent driven by the wall of liquidity created by central banks, and hence the all eyes are now on this unwinding of this liquidity. Based on our observation of past bull markets and the asset price inflation, we believe it is some time away for Fed action-induced correction in asset prices and financial markets.

While the markets are cautiously watching for the historical unwinding of liquidity scenario, we believe that event of global central banks tapering their asset purchases is still a quarter or two away and the subsequent increase in interest globally will take longer than that. While the tapering of bond buying program by the US Fed may begin some time in next few months, this means liquidity infusion would continue to happen albeit at a slower pace.

We believe, the financial markets would continue to rise steadily till we actually see a tighter liquidity and eventual higher interest rates and during this time I believe it's prudent to stay invested in companies with strong management quality, technology leadership and tangibility in business model.